the Quadrant group

Peer-to-peer lending – a fad or the future?

Summary

Much has been written over the years about the increasing disintermediation of the banks. Their traditional role as lenders and - via their investment banks – issuers of equity capital, has been undermined by other market participants such as hedge funds, mutual funds and private equity firms. Now, individuals are beginning to participate in this process too, lending to individuals via peer-to-peer lending schemes and raising equity capital via crowd funding in search of a return. This note explores peer-to-peer lending. Conclusion: not mainstream any time soon, higher risk than first appears, but an interesting innovation worth keeping an eye on.

Newsletter September 2015

Peer-to-peer lending – a fad or the future?

> *'Peer-to-peer looks like saving, tastes like saving, but as there's no savings safety guarantee, it smells like an investment.'*
>
> *Martin Lewis – Money Saving Expert*

Banks beware – crowdfunding is here (and here to stay)

Something quite remarkable is going on in the world of finance; it is the disintermediation of traditional financial services providers. The internet is revolutionising the way in which consumers access traditional financial services. Fewer people use bank branches because of online banking. Many people buy insurance via the internet using comparison websites. Crowdfunding is one such area where the middle man (the bank) is being replaced by internet based models. Put simply, crowdfunding is raising money by matching those who need it with those who want to supply it for some sort of reward, using an internet-based platform to do so. This was traditionally the preserve of the banks, particularly when it came to lending money.

A number of crowdfunding models exist. Donation-based crowdfunding is where individuals make donations to good causes they want to support without the expectation of a financial reward. Pre-payment or rewards-based crowdfunding is where individuals provide funding to a company, for example to fund the product development of a technology gadget, in return for the gadget once it is finally manufactured. Neither of these models is regulated by the Financial Conduct Authority (FCA). Zero return of your money with no reward should be the base expectation!

Two regulated models exist. The first is investment-based crowdfunding, where individuals purchase shares in a business that is looking for equity capital. Whilst this model has received quite a bit of press coverage, it actually represents a very small proportion of the overall crowdfunding market. It is a very high risk approach, usually representing early or start-up finance for very small businesses, and best avoided by most.

The other, and perhaps the most interesting model, is loan-based crowdfunding, which is also known as peer-to-peer lending (P2P). This is where individual lenders i.e. those seeking a return on their money, are matched with individuals and companies seeking debt financing. This brief note focuses specifically on this area.

Caveat

It is important to note that any P2P platforms mentioned in this note are simply used to provide examples and insights into the P2P world. References to them are most definitely <u>not recommendations</u> to either invest this way or to use any specific providers. These are really early days in a new, exciting and largely untested area of finance. Caveat emptor!

A bit of background

The first peer-to-peer lender in the world was Zopa, who set up in 2005. The UK now has a legal definition of what constitutes a P2P loan (Regulatory Activities Order 36H) and since 1 April, 2014, P2P has been regulated by the FCA. The industry also has an industry body to promote it called the *Peer to Peer Finance Association* (www.p2pfa.info).

Approximately £3.2 billion has been lent so far in the UK and in the past 3 years lending has grown by over 150%[1]. P2P Business Lending was the largest category of alternative finance in 2014 (£765m), followed by P2P Consumer Lending (£575m) and Invoice Trading (£270m). Equity-based crowd-funding

[1] Robert Wardrop, Bryan Zhang, Raghavendra Rau and Mia Gray (2015), Moving Mainstream: The European Alternative Finance Benchmarking Report (2015 University of Cambridge and EY, February 2015)

– although perhaps higher profile – is insignificant in comparison (£85m)[2]. Industry estimates suggest that P2P lending will double in size every six months going forward. In 2014 around £1.2 billion was lent via online P2P platforms in the UK. The UK currently dominates the alternative finance space in Europe, representing around 75% of the market.

Current major players (definitely not recommendations!) include Zopa, RateSetter and Funding Circle. A quick look at the P2PFA website (above) provides a brief oversight of who the key players are and what they do.

How does it work?

The reality is that each P2P platform has its own, slightly different way of doing things. In essence, individual borrowers are matched directly, on a contractual basis, with individual lenders, using an online platform. Borrowers can choose the amount and term that they wish to borrow for and the rate of interest that they will be charged is related to these two factors along with their perceived credit worthiness. Their motivation might be, for example, to refinance their credit card debt, consolidate other debts, make home improvements, buy a car or a buy-to-let residential property, or to finance invoices (if a business).

Lenders get to choose how much and how long they will lend for and are quoted the interest rate they will receive. Some platforms allow lenders to choose the risk category of borrowers, which will impact on the rate of interest they earn. P2P providers take a fee for matching borrowers and lenders, sometimes from both parties. Different platforms tend to focus on different types of borrower, providing the opportunity to diversify by lending strategy, which makes very good sense.

Although this has the look and feel of a deposit, it most certainly is not. Loans made are not covered by FSCS compensation and lenders are contractually linked directly to specific borrowers, with the consequent risk of default on interest, principal or both. In the case of bank deposits, loans are on the balance sheet as assets and deposits as liabilities. Shareholder capital acts as a buffer between aggregate losses and depositors, with FSCS compensation standing as the line of last resort.

In P2P transactions a number of mitigants are in place to minimise the risk and impact of default:

- The first level of protection is the screening of borrowers using various credit checking services and in-house processes.
- The second level of protection is the diversification of risk, upfront, across a broad number of borrowers, either selected individually or by some sort of auto-allocation by the platform. Zopa, for example restrict lender exposure to a maximum of 2% to any one borrower.
- The third level is by the provision of a loss reserve pool, which is normally funded by part of the fee paid by borrowers. Net returns to lenders are obviously reduced, but this pool – hopefully large enough to cover the estimated loan default rate with a buffer margin – can be called upon by lenders to pay up if any of their individual loans default. The pool then holds the bad debt and seeks to recover it using some form of collection agency. Some platforms share losses across all lenders in the event that the loss reserve pool is insufficient to cover losses.
- The fourth level is the purchase of insurance in the form of default cover by the platform. This is only offered by some. Again, this will reduce net returns to lenders, but offers greater certainty of the return of principal.
- Finally, some loans are backed by security of some sort. In the case of buy-to-let, for example, this would be the property mortgaged.

What are the risks?

The reality of P2P is that it is sub-investment grade lending, where the risk of default is real. Individual default rates will rise at times of economic crisis and investors are directly linked to any losses.

[2] Numbers are from the study above and converted from Euros to GBP at a rate of 1.3.

Understanding the protections in place and how losses are distributed, or not, between lenders is important. Some of the key risks are highlighted below:

- *Defaulting borrowers:* defaults will generally be covered provided that they fall within the level of assets in the loss reserve pool. What happens when this pool is exceeded? Who bears the risk? Is it collectively shared or individually suffered?
- *Reliance on the operational capability of the platform:* A lender is entirely beholden to the processes and systems of the platform to allocate his/her capital as requested and to complete all the formalities accurately and in a timely manner. How can you know that this is robust? What happens if the system fails? What protection of records exists? How can a lender make sure that there is a permanent trail to their assets (loans)?
- *A lack of true insight into default risks:* current default rates look low, but what will they look like when another market event (e.g. credit crisis or economic downturn) happens? How will the less sophisticated lender know what risks they are taking? How robust are the credit rating capabilities of the platform?
- *Hacking/internet fraud:* How strong is the cyber security? What happens if money/details are hacked? Are they insured?
- *Fraud:* This is a possibility as many firms are starting up. The possibility of fraudulent sites or a lack of strong client asset ring-fencing is real. How can this be minimised? Looking at the FCA register is a start.
- *Bankruptcy and closure of the platform:* This is a capital intensive and competitive market. Bankruptcy cannot be ruled out. Firms must have a resolution plan in place to ensure loans continue to be serviced on behalf of lenders; this is an FCA requirement. How robust are these plans? Will they work in reality?
- *Scalability:* as the P2P market grows, will the supply of borrowers of reasonable credit quality match the supply of possible lenders? If not, there is a danger of money being lent to lower quality borrowers. That may be fine, provided these risks are adequately compensated, and lenders understand and accept this higher risk-return proposition fully.

It is evident that there are many more risks to be concerned about relative to placing a deposit.

Outcomes to date

Fortunately, there appears to be a tendency towards considerable openness and transparency in the P2P space. As an example, Zopa - the longest standing UK P2P lender – provides data on its website relating to the complete loan book outstanding, default targets versus actual defaults and historical data on assets and defaults since inception. Default rates have been low in recent times and below the expected default rate, except for 2008 when default rates rose to 5.54% against an expected 3.68%, at which time some investors are likely to have lost capital. Looking at the loan book today, £467 million in capital repayments of the original loans of £920 million have been made leaving around £450 million outstanding. Zopa's '*Safeguard Trust*' - the loss reserve pool funded by part of the borrowers' fee - stands at £9.6 million (at the end of June 2015) or around 2% of outstanding balances. On their current estimates they will need £8.2 to cover loan defaults.

So, to date, many lenders will have earned a favourable rate of return on their assets and without loss to capital, particularly when the income received is taken into account. Although no industry numbers are available, the returns will undoubtedly have been above the returns delivered by deposits.

It is worth noting that 'The Innovative Finance ISA' was announced in the recent budget, which allows investors to reap interest tax-free from P2P lending, from April 2016. The new ISA is not required to allow withdrawal within 30 days, unlike current ISAs. Getting a tax break may well accelerate P2P lending.

Conclusion

This is an exciting innovation and the disintermediation of the banks is a welcome development. Our conclusion is that P2P lending is definitely not the same as placing a deposit with a bank; it is a high yield fixed income play with real risks to both capital and interest, operating through new companies and new technology, with very little track record. That said, lenders who do their homework, understand the risks, undertake good due diligence and diversify between providers, strategies and borrowers stand to obtain a higher return on their capital than they are getting in traditional bank and building society products. Due diligence on the platform itself will be very important. With new entrants, the risk of fraud or corporate failure is a material issue.

This is an area of finance that we will put on a watching brief and will provide further updates as the market develops. As ever, please do not hesitate to call if you have any questions or comments.

Other notes and risk warnings

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